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No. 430

In the Supreme Court of the United States

OCTOBER TERM, 1946

UNITED STATES OF AMERICA, PETITIONER

v.

OGILVIE HARDWARE COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES.

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OPINIONS BELOW

The opinion of the district court (R. 17–25) is reported in 62 F. Supp. 338. The opinion of the circuit court of appeals (R. 34–38) is reported in 155 F. 2d 577.

JURISDICTION

The judgment of the circuit court of appeals was entered on May 24, 1946 (R. 38). The petition for a writ of certiorari was filed on August 22, 1946, and was granted on October 14, 1946 (R. 40). The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is entitled to a credit under Section 26 (c), (3) of the Revenue Act of 1936, as added by Section 501 of the Revenue Act of 1942, as a corporation "having a deficit in accumulated earnings and profits", where there is in fact no deficit unless there be subtracted from its earnings and profits the amount of a nontaxable stock dividend which the taxpayer had previously issued.

STATUTES AND OTHER AUTHORITIES INVOLVED

The pertinent provisions of the statutes and other authorities involved are set forth in the Appendix, *infra*, pp. 39-49.

STATEMENT

The facts, as stipulated (R. 12–17), may be summarized as follows:

The taxpayer, Ogilvie Hardware Company, Inc., was incorporated under the laws of Louisiana in 1907, with a capital stock of 1,000 shares of common stock of the par value of $100,000 issued and outstanding. It operated a wholesale hardware business in that State on a fiscal year basis, ending on May 31st of each year. (R. 12–13.)

The surplus of the corporation at the end of the fiscal year ending on May 31, 1924, was $149,306.43. On July 7, 1924, a one hundred percent dividend in common stock ($100,000 par

value) was issued, share for share, to its common stockholders, which was charged to surplus on the books of the taxpayer during the fiscal year 1925. After charging this dividend to surplus, paying a cash dividend of $14,681, and giving effect to the earnings for the year ending May 31, 1924, the corporation still had a surplus of $42,229.70. (R. 13.)

Subsequent to the declaration of the stock dividend, the taxpayer sustained operating losses, and on May 31, 1936, its books disclosed a deficit of $74,875.10. On May 31, 1937, the deficit shown on the books was $71,347.18, and on May 31, 1938, the deficit shown was $60,923.58. (R. 14.)

Upon examination of the taxpayer's income and excess profits returns for the fiscal years ending May 31, 1937, and May 31, 1938, the Commissioner of Internal Revenue made certain adjustments and assessed additional taxes, which were paid by the taxpayer. Of the total taxes paid by the taxpayer for those periods, $5,426.93 consisted of a surtax on undistributed profits for the fiscal year 1937, and $1,488.86 consisted of a surtax on undistributed profits for the fiscal year 1938. (R. 15, 16.)

Following the enactment of Section 501 of the Revenue Act of 1942, the taxpayer filed claims for refund of the surtax on undistributed profits in the amounts of $5,426.93 and $1,488.86, for the fiscal years 1937 and 1938, respectively, based

on the ground that it had a continuous "deficit" in accumulated earnings and profits on May 31, 1936, May 31, 1937, and May 31, 1938, which, on each of those dates, exceeded the total amount of its net income for the fiscal years ending with those dates, and that it was thus prohibited by Louisiana law from paying dividends to its stockholders. The Commissioner rejected the claims and thereafter the present suit was instituted to recover these amounts. (R. 16–17.)

The district court entered a judgment in favor of the taxpayer for the amount in suit (R. 27–28), and the circuit court of appeals affirmed (R. 38).

SPECIFICATIONS OF ERRORS TO BE URGED

The circuit court of appeals erred:

1. In holding that the taxpayer is entitled to a credit as a corporation having a deficit in accumulated earnings and profits within the meaning of Section 26 (c) (3) of the Revenue Act of 1936, as amended by Section 501 of the Revenue Act of 1942.

2. In holding that the state law is controlling in the determination of whether a corporation is a deficit corporation within the meaning of these provisions of the federal statute.

3. In holding that the report of the Senate Committee on Finance may not be resorted to as an aid in interpreting the statute.

4. In holding invalid the pertinent provision of the Treasury Regulations.

5. In holding that the 1924 stock dividend irrevocably took $100,000 out of distributable earnings and profits, or surplus, and converted it to capital for federal tax purposes.

6. In affirming the judgment of the district court.

SUMMARY OF ARGUMENT

I

The crucial words in Section 26 (c) (3) of the Revenue Act of 1936, so far as this case is concerned, are the words "deficit in accumulated earnings and profits". Neither the term "earnings and profits" nor the phrase "deficit in accumulated earnings and profits" is new to the federal tax law, and Congress, in Section 26 (c) (3), legislated in the light of the history of these terms and the special meaning they have acquired for federal tax purposes.

Under the federal revenue laws, the distribution of a nontaxable stock dividend cannot diminish the earnings and profits of a corporation. Such earnings and profits remain intact in the hands of the corporation available for future distribution as dividends. This principle has long been settled by judicial decision and has been clarified and enacted into statutory form by Congress in Section 115 (h) of the Revenue Act of 1936. The basic theory is that where a transaction is not recognized as a taxable distribution of earnings and profits it should not be recognized,

under the federal tax laws, as diminishing the amount of earnings and profits available for future distribution. Cf. *Commissioner* v. *Wheeler*, 324 U. S. 542, 546–547. And this Court has recognized that the distribution of a nontaxable stock dividend does not, for federal tax purposes, take the amount of such dividend out of distributable earnings and profits, or surplus, and convert it to capital. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283. Hence, such a distribution cannot contribute to a "deficit in accumulated earnings and profits" within the meaning of Section 26 (c) (3).

That this is true is conclusively shown by the legislative history of Section 26 (c) (3). But the court below refused to consider an unambiguous report of the Senate Committee on Finance which set out an example of the statute's operation within which the present case fits, on the ground that the language of Section 26 (c) (3) was too clear to permit of outside aids to construction. In thus refusing to give any weight to the report of the Committee of Congress which proposed Section 26 (c) (3), the court below employed a technique of statutory construction that is plainly at variance with the current of decision in this Court.

Finally, the applicable Treasury Regulation reflects a view wholly inconsistent with that taken by the court below. This regulation has been up-

held by the Tax Court, and represents, at the minimum, a permissible construction on a doubtful point by the officials charged with administering the law. As such, it should not be invalidated.

II

The decision of the court below, holding that because the taxpayer corporation had "a deficit and not a surplus" under Louisiana law, it is entitled to the credit under Section 26 (c) (3), is justified neither by the words of the statute nor by the Congressional purpose in enacting the Section.

There is nothing in the language of the statute requiring the inference that the term "deficit in accumulated earnings and profits" be read in any but the federal tax sense. Under the statute, the credit is available only (1) when the corporation has a "deficit in accumulated earnings and profits" in the federal tax sense, (2) when the corporation is "prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence" of such a deficit, and (3) when such provision was in effect prior to May 1, 1936. In applying these provisions, it is necessary to determine, first, whether there is a "deficit in accumulated earning and profits" in the federal tax sense; only when such a determination is made is it relevant to inquire whether state law forbids the payment

of dividends. The error of the court below was in applying state law criteria to the resolution of the first question.

Congress did not intend, by means of Section 26 (c) (3), to grant a credit to every corporation forbidden to pay dividends. The related provisions of Section 26 plainly do not grant the credit simply because of a ban on the payment of dividends; and subsection (c) (3), similarly, is limited in scope.

It cannot be supposed that Congress intended, by implication, to import state law concepts into Section 26 (c) (3)'s definition of "deficit in accumulated earnings and profits." This term has never acquired a fixed meaning either in corporate finance and accounting or for purposes of state or other regulatory laws. Where resort to local law is to be had, Congress has expressly provided for it by making the credit available only if there is a prohibition of law against the payment of dividends by a corporation which has already established that it has a "deficit in accumulated earnings and profits".

In the absence of express language or a necessary implication that local law was to play a greater part than that thus assigned to it, Section 26 (c) (3) should be construed in the light of the general Congressional purpose to establish a nation-wide scheme of taxation uniform in its application.

ARGUMENT

I

THE TAXPAYER DID NOT HAVE "A DEFICIT IN ACCUMULATED EARNINGS AND PROFITS" WITHIN THE MEANING OF SECTION 26 (C) (3) OF THE REVENUE ACT OF 1936

The taxpayer, in the computation of the surtax imposed by Section 14[1] of the Revenue Act of 1936 on its undistributed profits for the fiscal years ending in 1937 and 1938,[1] claims the amount of the deficit shown on its books in its surplus account on May 31, 1936, and on May 31, 1937, respectively, as a credit under Section 26 (c) (3) of the Revenue Act of 1936, as added by Section 501 of the Revenue Act of 1942 (Appendix,

[1] Section 14 (Appendix, *infra*, p. 39) imposed a graduated surtax upon the "undistributed net income" of corporations in excess of certain percentages of the "adjusted net income". The term "adjusted net income" was defined in that Section to mean the "net income" minus the sum of the normal tax imposed by Section 13 and the credit provided in Section 26 (a) relating to interest on certain obligations of the United States and government corporations. The term "undistributed net income" was defined as the adjusted net income minus the sum of the dividends paid credit provided in Section 27 and the credit provided in Section 26 (c), relating to contracts restricting dividends. This definition of "undistributed net income" was changed by a retroactive amendment to the Section made by Section 501 of the Revenue Act of 1942, c. 619, 56 Stat. 798, to provide for the allowance of certain other credits embraced within other amendments made by Section 501 of the Revenue Act of 1942, one of which amendments added Section 26 (c) (3) here involved.

infra, p. 41). It does so on the ground that it was, within the meaning of that Section, a corporation "having a deficit in accumulated earnings and profits as of the close of the preceding taxable year" which was prohibited by a provision of state law, in effect prior to May 1, 1936, "from paying dividends during the existence of a deficit in accumulated earnings and profits".

The only question presented is whether the amount of the nontaxable stock dividend issued by the taxpayer in 1924 ($100,000) may be subtracted from the taxpayer's accumulated earnings and profits in determining whether the taxpayer is a corporation "having a deficit in accumulated earnings and profits" within the meaning of Section 26 (c) (3).[2] If the $100,000 represented by the 1924 stock dividend charged on the taxpayer's books against its surplus account be treated as not having diminished the taxpayer's accumulated earnings and profits for purposes of determining whether the taxpayer is a deficit

[2] The petition for certiorari raised no question with respect to the holding below that taxpayer was prohibited by the law of Louisiana from paying dividends during the fiscal years ending in 1937 and 1938. And the taxpayer has not attempted to controvert the position of the Government that the 1924 stock dividend was a nontaxable dividend. The district court held (R. 21) that the 1924 dividend was nontaxable both under Section 201 (f) of the Revenue Act of 1924, c. 234, 43 Stat. 253, and under the decisions of this Court. Its decision in this respect is in accord with *Eisner* v. *Macomber*, 252 U. S. 189, and *Helvering* v. *Griffiths*, 318 U. S. 371.

corporation within the meaning of Section 26 (c) (3), then it may not be denied that the taxpayer had in the tax sense no deficit, but rather a surplus in its accumulated earnings and profits on each of the critical dates.

A. *The term "deficit in accumulated earnings and profits" has acquired a special meaning for federal tax purposes.*—That the term "earnings and profits" has a special meaning in the federal tax sense is no longer open to doubt. This Court specifically so held in *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, and the same conclusion is implicit in the decisions in *Commissioner* v. *Fisher*, 327 U. S. 512, and *Commissioner* v. *Estate of Bedford*, 325 U. S. 283. The phrase "earnings and profits" has a long history in the federal statutes, and in the absence of compelling evidence to the contrary it must be assumed that Congress legislated in the light of that history. Cf. *Estate of Sanford* v. *Commissioner*, 308 U. S. 39, rehearing denied, 308 U. S. 637. In all Revenue Acts beginning with that of 1916, the term has been used in defining "dividend" as meaning any distribution made by a corporation to its stockholders out of its "earnings or profits" accumulated after February 28, 1913.[3] The phrase "earnings and profits" appears as well in numer-

[3] Section 2 (a) of the Revenue Act of 1916, c. 463, 39 Stat. 756; Section 201 (a) of the Revenue Act of 1918 through 1926; and Section 115 (a) of subsequent Acts and the Internal Revenue Code.

ous other sections of the Revenue Acts. For example, see the Revenue Act of 1936, Sections 26 (c) (2), and (e), 27 (f), 102 (a), 112 (c) (2), 115 (a), (b), (c), (e), (g) and (h), and 351. And the phrase "deficit in the accumulated earnings and profits" is used in Section 27 (a) (3) of the Revenue Act of 1938, c. 289, 52 Stat. 447.[4]

While the term "earnings and profits"[2] has never been comprehensively defined in the federal statutes, its meaning has frequently been a matter of consideration for the administrative authorities and the courts. The meaning of the term, in certain of its aspects, has been crystallized in regulations of the Treasury Department and in court decisions, and Congress has enacted statutes to clarify and to put into statutory form some of the conclusions of the administrative and judicial branches as to the meaning of the term in the tax sense. Thus, in Section 501 of the Second Revenue Act of 1940, 54 Stat. 974, which antedated Section 26 (c) (3) here involved by approximately two years, and which came before this Court in *Commissioner* v. *Wheeler* referred to *supra*, p. 11, Congress adopted a clarifying amendment with

[4] In *Chapman Price Steel Co.* v. *Commissioner*, 146 F. 2d 189 (C. C. A. 7), certiorari denied, 325 U. S. 876, it was held that the issuance of a nontaxable stock dividend would not result in the depletion of the corporation's earned surplus so as to create a "deficit in accumulated earnings and profits" within the meaning of Section 27 (a) (3) of the Revenue Act of 1938. The reference in the opinion to the Revenue Act of 1936 seems to be a typographical error.

respect to the effect of gain or loss realized but not recognized under the revenue laws and the effect of the receipt of certain tax-free distributions on "earnings and profits". In view of the antecedent history of the use of the term "earnings and profits" and the term "deficit in earnings and profits" in the federal tax statutes, it must be assumed that Congress intended, in that portion of Section 501 of the Revenue Act of 1942, which added Section 26 (c) (3) to the Revenue Act of 1936, to use the terms in a sense no different from that in which they were used in other provisions of the tax statutes.

What we are particularly concerned with here, of course, is the effect on "earnings and profits" of the distribution of a nontaxable stock dividend. Congress has not left that question at large in the revenue laws. Even prior to the development in the case of *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2), certiorari denied, 287 U. S. 667, of the principle that what is not "recognized" under the Revenue Acts as a sale or disposition for the purpose of fixing gain or loss should not be "recognized" as changing accumulated profits into capital, there had developed the principle that a nontaxable stock dividend does not effect a distribution of the earnings and profits of the corporation issuing such dividend but, rather, that these accumulations remain untouched and are available for future distribution.

Walker v. *Hopkins*, 12 F. 2d 262, 263 (C. C. A. 5), certiorari denied, 271 U. S. 687; *Wilson* v. *Commissioner*, 3 B. T. A. 957; *Kennish* v. *Commissioner*, 4 B. T. A. 303; *Megrath* v. *Commissioner*, 5 B. T. A. 1274, 1284; *Hedrick* v. *Commissioner*, 24 B. T. A. 444; *Untermyer* v. *Commissioner*, 24 B. T. A. 906, affirmed, 59 F. 2d 1004 (C. C. A. 2), certiorari denied, 287 U. S. 647; *McCulloch* v. *Commissioner*, 29 B. T. A. 67; *McCord* v *Commissioner*, 31 B. T. A. 342; *Horrmann* v. *Commissioner*, 34 B. T. A. 1178. See also *Noldè* v. *United States*, 64 C Cls. 204, certiorari denied, 276 U. S. 634.

The principle of the *Sansome* case and the principle that a nontaxable stock dividend does not diminish a corporation's accumulated earnings and profits were both approved by Congress and, in the interest of greater clarity, were put into statutory form in Section 115 (h) of the Revenue Act of 1936 (Appendix, *infra*, p. 43). That Section provides as follows:

> (h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—
>
> (1) if no gain to such distributee from

the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee, because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

The purpose of Congress in enacting Section 115(h) is set forth clearly in S. Rep. No. 2156, 74th Cong., 2d Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690).[5] There can be no doubt from

[5] The Committee stated:

Section 115 (h). *Effect of Distributions on Earnings and Profits.*

The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law, is a nontaxable stock dividend or a distribution of stock or securities in connection with a reorganization or other exchange, on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. This rule is stated only in part in section 115 (h) of the Revenue Act of 1934, and corresponding provisions of prior Acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner* v. *Sansome* (60 Fed. (2d), 931); *United States* v. *Kauffman* (62 Fed. (2d), 1045);

the language of Section 115 (h) and the explanation of that Section in the Senate Committee Report that a nontaxable stock dividend is deemed not to diminish the earnings and profits of a corporation but that such earnings and profits remain intact and hence available for future distribution. The subdivision does not state that earnings and profits are not reduced by such stock dividends for certain purposes only, and its applicability is not limited to particular sections of the Revenue Act. In that respect it is like Section 115 (a). See *Commissioner* v. *Estate of Bedford*, 325 U. S. 283.

Subsequent to the enactment of the Revenue Act of 1936, the Treasury Regulations have consistently applied the rule that distributions of nontaxable stock dividends do not diminish earnings and profits for any purpose. Treasury Regulations 94 and 101, Article 115–11; Treasury Regulations 103, Section 19.115–11, and Treasury Regulations 111, Section 29.115–11. And decisions of the courts have, with few exceptions, recognized and applied the rule. *Long* v. *Commissioner*, 155 F. 2d 847 (C. C. A. 6th); *Chapman Price Steel Co.* v. *Commissioner*, 146 F. 2d 189 (C. C. A. 7), certiorari denied, 325 U. S. 876; *Beretta* v. *Commissioner*, 141 F. 2d 452

Murcheson v. *Comm.* (76 Fed. (2d), 641). While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interest of greater clarity.

(C. C. A. 5), certiorari denied, 323 U. S. 720; *Van Norman Co.* v. *Welch*, 141 F. 2d 99, 102 (C. C. A. 1).

B. *The distribution of a nontaxable stock dividend cannot contribute to the creation of a "deficit in accumulated earnings and profits" under Section 26 (c) (3).*—Section 26 (c) (3), as retroactively added by Section 501 of the Revenue Act of 1942, provides that in the case of a corporation a credit shall be allowed as follows:

> (3) *Deficit Corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

Properly read, the provisions of Section 26 (c) (3) will be seen to fall into three parts, and it is clear that the taxpayer must show that he has satisfied each of the three requirements thus stated in order to be entitled to the credit granted by the Section. The first part of the Section, which reads "In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit", constitutes the grant of

the allowance. Such grant, however, is upon two further conditions which are expressed in the latter part of the Section: (1) "if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits", and (2) "if such provision was in effect prior to May 1, 1936."[6] Literal compliance with the terms of the statute is required. The statute grants a credit in the "nature of a specially permitted deduction", and should be strictly construed. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49; *Sumter Farm & Stock Co.* v. *United States*, 151 F. 2d 975 (C. C. A. 5). We think it plain that the term "deficit in accumulated earnings and profits", so construed, carries with it the federal tax concept, outlined above, *supra*, pp. 13–17, that the distribution of a nontaxable stock dividend cannot contribute to the creation of such a deficit.

This textual analysis of the terms of Section 26.(c) (3), as requiring that there be a "deficit in accumulated earnings and profits" in the

[6] The first of these two conditions was inserted in the statute apparently in recognition of the fact that under local law in some States, corporations may pay dividends notwithstanding the existence of a deficit in its earnings and profits. See, e. g., *Sumter Farm & Stock Co.* v. *United States*, 151 F. 2d 975 (C. C. A. 5). The second condition was undoubtedly included in the statute to preclude a circumvention of the intent of Congress by subsequently enacted local laws.

federal tax sense, is confirmed not only by the fact as shown above (*supra*, pp. 11–17), that the term has a special meaning for tax purposes, but also by the legislative history of Section 26 (c) (3) itself. The relevant legislative material conclusively demonstrates that the distribution of a nontaxable stock dividend does not affect the amount of accumulated earnings and profits. The intent of Congress in the enactment of Section 501 of the Revenue Act of 1942, which added Section 26 (c) (3) to the Revenue Act of 1936, was clearly set forth in a report of the Senate Committee on Finance in which any opportunity for ambiguity was virtually eliminated by an example showing the operation of the statute as follows (S. Rep. No. 1631, Appendix, *infra*, pp. 47–49):

> Assume in the above example[7] that the deficit in accumulated earnings and profits is $20,000 for income tax purposes, but the deficit in accumulated earnings and profits on the corporation's books by reason of a prior capitalization of surplus in the course of a nontaxable reorganization amounts to $250,000. In this case, although the State law would probably prohibit payment of any dividends, the credit allowed under the amendment to section 26 (c) is limited to $20,000, which is the deficit in accumulated earnings and profits for income tax pur-

[7] The "above example" referred to X corporation which had an adjusted net income of $200,000.

poses. X corporation, therefore, will be liable for undistributed profits surtax on $180,000 of its adjusted net income.

The conclusion is inevitable, from the explanation contained in the Senate Committee report, that the intention of Congress was that a deficit in earnings and profits within the meaning of Section 26 (c) (3) would not exist by virtue of the fact that in computing its book deficit, a corporation treated an earlier nontaxable stock dividend as diminishing "earnings and profits". While it is true that the example refers to a nontaxable reorganization, the same principle is applicable in determining the effect on earnings and profits of a nontaxable stock dividend as in determining the effect of a nontaxable reorganization on such earnings and profits. The example draws a distinction between a deficit in accumulated earnings and profits "for income tax purposes" and the deficit in accumulated earnings and profits on the corporation's books "by reason of a prior capitalization of surplus" in the course of a nontaxable reorganization, and states that although the state law would probably prohibit payment of any dividends, the credit allowed under the amendment to Section 26 (c) is limited to the "deficit" in accumulated earnings and profits for income tax purposes.

The intention of Congress is confirmed by reference to H. Rep. No. 2894, 76th Cong., 3d Sess.,

p. 41 (1940–2 Cum. Bull. 496, 526–527) dealing with Section 401 of the Second Revenue Bill of 1940 [Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974], which inserted the new subsection (l) in Section 115 of the Internal Revenue Code and correspondingly amended prior Revenue Acts.[8] This report was cited by this Court in *Commissioner* v. *Wheeler*, 324 U. S. 542, with approval. The report shows clearly that while Congress was, in that Section, clarifying the law with respect to what constitutes earnings and profits of a corporation, it intended that rule to be taken in conjunction with Section 115

[8] H. Rep. No. 2894, p. 41 reads in part as follows:

Section 401. Earnings and profits of corporations.

"The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the Bill inserts subsection (l) in section 115 of the Internal Revenue Code and correspondingly amends prior revenue acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome*, 60 F. (2d) 931, and following decisions, the rule effectuates the provisions of section 112. * * *"

(h) of the Revenue Act of 1936 and the principles of *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2), certiorari denied, 287 U. S. 667, and the decisions which followed that case.

The court below refused to give any weight to S. Rep. No. 1631, explaining the new Section 26 (c) (3), on the ground that the meaning of Section 26 (c) (3) was too clear to permit of reference to outside aids to construction, although the court itself adverted to (R. 35), and was seemingly influenced by, what it considered to have been the purpose of Congress in enacting that Section, and although the Tax Court and the Circuit Court of Appeals for the Eighth Circuit in *Century Electric Co.* v. *Commissioner*, 3 T. C. 297, affirmed, 144 F. 2d 983, referred to in the opinion below, had both reached a conclusion as to the meaning of Section 26 (c) (3) contrary to that of the court below. The court pointed out its basis for disregarding the committee report and the regulations in the following analysis of the legislative process (R. 37):

> It [the example] is merely the opinion of the writer of the report on how the legislation would work out in the case of a nontaxable reorganization. The Constitution, Article 1, Section 7, states how the laws of the United States are made: by written Bill, passed by the House and Senate separately, transmitted to the President and approved by him, or passed over his veto.

> The provision is express that thus "the same [the Bill] shall be a Law." The report of a Committee of the Senate is not voted on—perhaps not read by—the members even of the Senate; but the words of the Bill are. The Bill is transmitted to the House, and it—not the Committee's report—is passed there. The Bill is then sent to the President for his approval. He does not approve a Committee report, if by any chance he should see it. He approves the words of the Bill and it becomes the law. Under the statutes on the subject the Bill as soon as passed by either House is printed and becomes the authentic Bill: 1 U. S. C. A. § 26. On final passage and printing, 44 U. S. C. A. § 196, the printed Acts are evidence of the laws passed; 1 U. S. C. A. § 30. The words of the Act are the law. Only when the words of the law are difficult of understanding can what happened in passing it be resorted to for aid. Its clear meaning cannot be so altered. Nor can anything be thus added to it. Nor can putting an example into the Regulation add to or change the law as passed.

This technique of statutory construction is, we submit, plainly at variance with the current of decision in this Court. In *Harrison* v. *Northern Trust Co.*, 317 U. S. 476, this Court said (p. 479):

> But words are inexact tools at best, and for that reason there is wisely no rule of law forbidding resort to explanatory legislative history no matter how "clear the

words may appear on 'superficial examination' ".

The same view was expressed in *United States* v. *Amer. Trucking Ass'ns,* 310 U. S. 535, 543–544, and in *United States* v. *Dickerson,* 310 U. S. 554, 561–562. If the proper consideration and weight be given to the legislative history of Section 26 (c) (3), the conclusion is compelled that the taxpayer is not entitled to a credit as a deficit corporation under that Section.

As has already been indicated, the Tax Court and the Circuit Court of Appeals for the Eighth Circuit, in *Century Electric Co.* v. *Commissioner,* 3 T. C. 297, affirmed, 144 F. 2d 983, concurred in holding that the meaning of "a corporation having a deficit in accumulated earnings and profits" as used in Section 26 (c) (3), here involved, is controlled by the federal rule, and that Section 115 (l) of the Revenue Act of 1936 is applicable and precludes the reduction of the earnings and profits of a corporation on account of nontaxable stock dividends for purposes of computing a deficit under Section 26 (c) (3) for which credit is given by that Section.[9]

[9] The taxpayer attempts to distinguish the *Century Electric Co.* case (Br. in Opp., pp. 6–8), contending that the stock dividends were declared by the corporation during the years 1936 and 1937, which were the tax years there involved. The Tax Court in that case did not find that the stock dividends were distributed in 1936 and 1937, nor does it appear from the opinion of the circuit court of appeals in that case that that court regarded the dividends as having been distributed

The court below held (R. 37–38) that Section 115 (h) has no bearing on Section 26 (c) (3) on the ground that Section 26 (c) (3) relates to the taxation of the corporation itself while Section 115 (h) has reference not to the taxes or credits of the corporation but only to the taxation of the shareholder.[10] We submit that the court in this respect has failed to give to Section 115 (h) its proper operative effect. As the language of

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in such years. The record in that case showed that the stock dividends had been declared in earlier years, and it was only by such earlier distributions that the taxpayer could have hoped to come under Section 26 (c) (3), for that Section speaks of a deficit "as of the close of the preceding taxable year". And if the nontaxable stock dividends were issued during the taxable years involved in that case, Section 27 (h) of the Revenue Act of 1936 (Appendix, *infra*, pp. 42–43) would have prevented a dividends paid credit. Finally, it is difficult to see in any case how a stock dividend declared "out of earnings and profits" can directly create a deficit in the earnings and profits. The holding in that case was that "earnings and profits" are not diminished by a nontaxable stock dividend and accordingly that in the federal tax sense no deficit arose, since, disregarding the stock dividend, the accumulated earnings and profits exceeded subsequent operating losses of the taxpayer.

[10] The Circuit Court of Appeals for the Sixth Circuit in *United States* v. *Byron Sash & Door Co.*, 150 F. 2d 44, and the District Court for the Eastern District of Pennsylvania, in *Philadelphia Carpet Co.* v. *United States*, decided August 30, 1946 (1946 C. C. H., par. 9350), are in accord with the court below. Compare, however, the later decision of the Sixth Circuit in *Long* v. *Commissioner*, 155 F. 2d 847, in which that court held that the capitalization of earnings and profits by the issuance of nontaxable stock dividends did not result in changing the earnings into capital for federal tax purposes.

that Section and its legislative history clearly show, its purpose was to crystallize into a statutory provision the rule with regard to the effect upon "earnings and profits" of a corporation of certain nontaxable corporate exchanges and nontaxable dividends. When Congress, in 1942, added Section 26 (c) (3) to the Revenue Act of 1936, using therein the term "earnings and profits", it employed that term in the tax sense, and the term in the tax sense must be read in conjunction with Section 115 (h).

In the court below, the taxpayer advanced the contention that Section 115 (h) was not applicable because it provides that a nontaxable stock dividend shall not be considered a "distribution" of earnings and profits. The taxpayer's position is that it may readily concede that its 1924 stock dividend did not effect a "distribution" of earnings and profits, but, it contends, such stock dividend did effect a "capitalization" of $100,000 of its accumulated earnings and profits, and that its earnings and profits were therefore depleted to that extent. For its position in this regard, the taxpayer relied below, and in its brief in opposition to certiorari, upon certain state court decisions and upon the following federal court decisions: *Eisner* v. *Macomber*, 252 U. S. 189; *Commissioner* v. *Cordingley*, 78 F. 2d 118 (C. C. A. 1); *Patty* v. *Commissioner*, 98 F. 2d 717 (C. C. A. 2); *Commissioner* v. *Champion*, 78

F. 2d 513 (C. C. A. 6); *Commissioner* v. *Quackenbos*, 78 F. 2d 156 (C. C. A. 2), and *Commissioner* v. *Ahlborn*, 77 F. 2d 700 (C. C. A. 3). See Br. in Opp., pp. 17–22.

For present purposes, it is immaterial that under state law a stock dividend is treated as capitalizing earnings and profits. Cf. *Commissioner* v. *Wheeler*, 324 U. S. 542. The case of *Eisner* v. *Macomber, supra*, presented the question of the constitutional validity of an income tax upon a true stock dividend, and the basis of the decision was that such a dividend does not effect a distribution of the corporation's earnings. The other federal decisions involved Section 115 (g) of the Revenue Act of 1928, c. 852, 45 Stat. 791, or comparable provisions of other Revenue Acts relating to the cancellation or redemption by a corporation of its stock "at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend."

We submit that the decision of this Court in *Commissioner* v. *Estate of Bedford*, 325 U. S. 283, in effect overrules the circuit court of appeals decisions in the *Cordingley*, *Patty* and similar cases cited above. The Circuit Court of Appeals for the Second Circuit in *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23, agreed that this was the effect of the *Bedford* decision, and there

seems little ground to doubt the accuracy of this conclusion. In the *Bedford* case, this Court, reversing the decision of the Second Circuit in that case which had relied upon the *Patty* and *Quackenbos* cases, *supra*, recognized that a distribution of cash by a corporation was out of earnings and profits and had the effect of the distribution of a taxable dividend under Section 112 (c) (2) of the Revenue Act of 1936, notwithstanding the fact that the books of the corporation showed a deficit in the surplus account because earlier nontaxable stock dividends had been charged against it. We believe it to be beyond question from the *Bedford* decision that the distribution of a nontaxable stock dividend does not convert earnings and profits into capital for federal tax purposes.[11]

[11] It may be noted that in the Excess Profits Tax Act of 1940, enacted by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, where "capital" of a corporation has become a relevant factor in determining a corporation's taxes, Congress has provided in Sections 713 (c) (3) and 718 (c) (1), that a distribution by a corporation to its shareholders in its stock or rights to acquire its stock "shall not be regarded as money or property paid in for stock, or as paid in surplus, or as a contribution to capital". In Section 718 (a) (3), distributions of stock are included in equity invested capital to the extent to which they are considered "distributions of earnings and profits" and in Section 718 (a) (4) "accumulated earnings and profits" are included in equity invested capital. In H. Rep. No. 2894, 76th Cong., 3d Sess., p. 24 (1940-2 Cum. Bull. 496) it was stated that taxable stock dividends are included in invested capital because they represent, in effect, a reinvestment of earnings in the business, but that, conversely,

To conclude that a nontaxable stock dividend may not create or contribute to a deficit in accumulated earnings and profits within the meaning of Section 26 (c) (3) of the Revenue Act of 1936, as added in 1942, is to harmonize that Section with the Congressional purpose evidenced in Section 27 (h) of the Revenue Act of 1936 (Appendix, *infra*, pp. 42–43), which prohibits a dividends paid credit if any part of a distribution, including stock dividends, is not a taxable dividend. If a credit may not be secured by virtue of the distribution of a nontaxable stock dividend in the year of distribution, there would seem to be little reason to suppose that Congress intended that such a distribution might form the basis for a credit in succeeding years. The legislative history of Section 501 of the Revenue Act of 1942, which added Section 26 (c) (3) to the Revenue Act of 1936, clearly indicates, as we have shown, that it was not the purpose of Congress to allow such a credit.

Finally, it may be observed that the present case involves in substance the same principle which formed the basis of this Court's decision

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"if a stock dividend was not subject to tax in the hands of the distributee because it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or was no taxable to him under the applicable revenue law, it is not deemed to reduce the earnings and profits account and is therefore already reflected in the accumulated earnings and profits".

in *Commissioner* v. *Wheeler*, 324 U. S. 542. In that case, the Court pointed out that Congress has determined that in certain types of transactions the economic changes are not definitive enough to be given tax consequences, and the Court stated (p. 546) that it is sensible to carry through the theory in determining the tax effect of such transactions on "earnings and profits". In that connection, this Court cited with approval the case of *Commissioner* v. *Sansome*, and S. Rep. No. 2156, cited *supra*, p. 15. It could hardly be contended, in view of the *Wheeler* decision, that problems of the basis to be used in computing "earnings and profits" and the time at which realized but unrecognized gains and losses are to be brought into "earnings and profits" are to be decided one way in determining income tax and another way in determinifig the undistributed profits tax credit. We believe it apparent that Congress intended a uniform rule to be applied. By the same reasoning, Congress plainly intended, we submit, that the uniform rule to the effect that nontaxable stock dividends do not diminish "earnings and profits" should also be applied in determining whether a corporation has a deficit in accumulated earnings and profits under Section 26 (c) (3).

C. The Treasury Regulation, which limits the credit under Section 26 (c) (3) to a "deficit in accumulated earnings and profits" in the federal

tax sense, is a valid exercise of the rule-making power.—The example illustrating the application of the provisions of Section 26 (c) (3) contained in S. Rep. No. 1631, referred to above, pp. 19–20, is also contained in Article 26–2 of Treasury Regulations 94 (Appendix, *infra*, pp. 45–47). As we have heretofore pointed out, this example, while in terms referring to a deficit in accumulated earnings and profits on the corporation's books by reason of a prior capitalization of surplus in the course of a nontaxable reorganization, establishes the principle that the credit which is allowable under Section 26 (c) (3) is the deficit in accumulated earnings and profits for federal income tax purposes irrespective of whether state law may attribute a different meaning to the term.

The administrative practice established in these regulations has been approved by the Tax Court in *Century Electric Co.* v. *Commissioner*, 3 T. C. 297, affirmed, 144 F. 2d 983 (C. C. A. 8). The Treasury Department's construction of the statute is not unreasonable or inconsistent with the statute and should be upheld. At the minimum it represents a permissible construction upon a doubtful point by the officials charged with administering the law, and there should be more weighty reasons than are here apparent for disturbing this administrative construction. Cf. *Commissioner* v. *Wheeler*, 324 U. S. 542; *Fawcus*

Machine Co. v. *United States*, 282 U. S. 375, 378; *Brewster* v. *Gage*, 280 U. S. 327, 336. See also *Great Lakes Coca-Cola Bot. Co.* v. *Commissioner*, 151 F. 2d 174 (C. C. A. 7), upholding a provision of the same regulation as is here involved.

II

THE COURT BELOW ERRED IN IMPORTING CONCEPTS OF STATE LAW INTO THE TERM "DEFICIT IN ACCUMULATED EARNINGS AND PROFITS"

Despite the special meaning which has been given the term "earnings and profits" in federal tax law generally, and in Section 26 (c) (3), and despite the Treasury Regulation to the contrary, the court below granted a credit to the taxpayer corporation because a corporation which exists under Louisiana law and "has a deficit and not a surplus under that law and is thereby prevented from paying dividends, is a corporation protected by" Section 26 (c) (3) (R. 36). This conclusion is justified neither by the words of the statute nor by the Congressional purpose in enacting Section 26 (c) (3).

Nothing in the two uses of the phrase "deficit in accumulated earnings and profits" in Section 26 (c) (3) requires that that term be read in the light of state law, as the court below thought it should, to avoid attributing a different meaning to the term used the first time from that given to it in its second use (cf. R. 36). Properly read,

Section 26 (c) (3) means, as has been shown (*supra*, pp. 17–30), that the credit is available to a corporation having a "deficit in accumulated earnings and profits" in the federal tax sense if that corporation is prevented by law or order of a public regulatory body, in effect before May 1, 1936, from paying dividends when it has a "deficit in accumulated earnings and profits" within the meaning of federal tax law.

That Congress could not have intended to grant a credit to every corporation forbidden to pay dividends, as the court below apparently assumed, is manifest not only from the language it used in Section 26 (c) (3), but also from the related provisions in Section 26 (c) (1) and (2). See *infra*, pp. 40–41. Under these provisions, oral contracts forbidding dividends,[12] or restrictions imposed within the body corporate,[13] for example, will not afford a basis for the credit. The credit under Section 26 (c) (3), similarly, is limited and is granted only to corporations having a deficit in accumulated earnings and profits. It follows that a ban on distributions, whether by state law or otherwise, is not itself determinative; what is required is a literal compliance with the terms of the federal statute.

It cannot be supposed that Congress intended, by implication, to import state law concepts into

[12] *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 52.

[13] *Hercules Gasoline Co.* v. *Commissioner*, 326 U. S. 425.

Section 26 (c) (3) when it did no such thing in the other subdivisions of Section 26. Cf. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49; *Helvering* v. *Northwest Bancorporation*, 140 F. 2d 958 (C. C. A. 8), certiorari denied, 322 U. S. 726. Section 14 of the Revenue Act of 1936 (Appendix, *infra*, p. 39), which imposes the surtax on undistributed profits, itself indicates that there is a correlation between the various provisions of that Section and also between Section 26 and Section 27. Appendix, *infra*, pp. 40–43. This conclusion is strengthened by Section 26 (c) (4) of the Revenue Act of 1936, as amended by Section 501 of the Revenue Act of 1942 which is headed "Double Credit Not Allowed", and provides that if more than one of the credits provided in subdivisions (c) (1) and (c) (2) and the new subdivision (c) (3) of Section 26 apply, then the paragraph which allows the greatest credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied. Congress has thus indicated that it considered the three subdivisions as interdependent since it has made the relief obtainable under one paragraph exclusive. Cf. *Hercules Gasoline Co.* v. *Commissioner*, 326 U. S. 425. It is untenable, therefore, to conclude that Congress used the term "earnings and profits" in a different sense in the interdependent subsections. If there could be

any doubt of this, it would seem to be resolved by that portion of Section 501 of the Revenue Act of 1942 adding a new subsection (f) to Section 26 of the Revenue Act of 1936 (Appendix, *infra,* pp. 41–42) headed "Deficit Credit" in which the term "earnings and profits" appears several times, and as to which there can be no question that such "Deficit Credit" was not made to depend upon what might be considered a deficit in earnings and profits under state law.

Moreover, the terms "earnings and profits" and "deficit in accumulated earnings and profits" have never acquired a fixed meaning either in corporate finance and accounting or for purposes of state or other regulatory laws. These terms are unlike the word "surplus", which is commonly employed to designate an account on the corporate books representing the net assets of a corporation in excess of all liabilities including its capital stock. Cf. *Edwards* v. *Douglas,* 269 U. S. 204, 214. Indeed, the statute of Louisiana here involved (Appendix, *infra,* pp. 43–45) prohibits the payment of dividends "except from the surplus of the aggregate of its assets over the aggregate of its liabilities, plus the amount of its capital stock". The term "deficit in accumulated earnings and profits" is not used in the Louisiana statutes, nor does it appear that such term would have any fixed meaning under the law of that State. Other State limitations on dividend distri-

butions use phrases such as net earnings, surplus arising from the business earnings, actual net earnings, actual legitimate net earnings, profits earned by the business, net profits, profit, accumulated profits, net profits actually acquired, profits actually earned and on hand, and net profits properly applicable thereto. Not only does there seem to be no settled usage with respect to these terms in commerce, but it has been said that the economists themselves are at hopeless loggerheads. Weiner, *Theory of Anglo-American Dividend Law* (1929), 29 Col. L. Rev. 461.

It is true that under Section 26 (c) (3) it is necessary to look to local law or to orders of public regulatory bodies to determine whether there is a prohibition against the payment of dividends by the taxpayer corporation during the existence of a deficit in accumulated earnings and profits, but resort to local law or to orders of public regulatory bodies for this limited purpose is permitted only because Congress has *expressly conditioned* the right to the prescribed credit upon a showing of the existence of such a prohibition under a provision of a law or of an order of a public regulatory body. This does not mean, however, that the question of the amount of the credit to which the taxpayer will become entitled, namely, the amount of the deficit, or the question whether the taxpayer in fact has a deficit in accumulated earnings and profits within the mean-

ing of Section 26 (c) (3) is to be determined by state law, as held by the court below. Under the wording of Section 26 (c) (3), there would be no greater justification for resorting to state law in the determination of the existence and amount of a deficit than there would be in resorting to orders of public regulatory bodies in the determination of such questions, and there has been no suggestion by the taxpayer or by the court below that orders of such bodies may be resorted to for that purpose.

The federal revenue laws are designed to establish a nation-wide scheme of taxation uniform in its application and they should be construed in the light of this general purpose. There is no language or necessary implication in that portion of Section 26 (c) (3) which constitutes the grant of the allowance, namely, "In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit", which makes its operation dependent upon state law. It is clear, we submit, that Congress did not intend to relegate the many troublesome questions concerning the existence and amount of accumulated earnings and profits for purposes of Section 26 (c) (3), here involved, to the uncertain field of local law, when Congress itself had, prior to the enactment of the Revenue Act of 1942, recognized the existence of the uncertainties of state law, and

had adopted legislation to resolve some of the more difficult questions. Cf. *Commissioner* v. *Wheeler*, 324 U. S. 542; *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46; *United States* v. *Pelzer*, 312 U. S. 399, 403; *Lyeth* v. *Hoey*, 305 U. S. 188, 193; *Burnet* v. *Harmel*, 287 U. S. 103, 110.

CONCLUSION

The decision below is erroneous and should be reversed.

Respectfully submitted,

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JANUARY 1947.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate * * *

(D) In the case of a national mortgage association * * *

(2) [as amended by Section 501 of the Revenue Act of 1942, c. 619, 56 Stat. 798] The term "undistributed net income" means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payments of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g).

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

* * * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(a) *Interest on Obligations of the United States and Its Instrumentalities.*—* * *

(b) *Dividends Received.*—* * *

(c) [as amended by Section 501 of the Revenue Act of 1942] *Restrictions on Payment of Dividends.*—

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such

amount has been so paid or set aside. For the purpose of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Deficit corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

(4) *Double credit not allowed.*—If more than one of the credits provided in the foregoing paragraphs (1), (2), and (3) apply, then the paragraph which allows the greatest credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(d) *Bank Affiliates.*—* * *

(e) *National Mortgage Associations.*—* * *

* * *

(f) [as added by Section 501 of the Revenue Act of 1942] *Deficit Credit.*—The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and (2) the earnings and profits of the taxable year (computed as of the

close of the taxable year without diminution by reason of any distributions made during the taxable year. For the purposes of this subsection, earnings and profits of the taxable year shall be computed without diminution by the amount of the tax imposed under section 14, 102, 103, or 351 for such taxable year; and earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, shall be diminished on account of the tax under section 14, 102, 103, or 351 for any previous taxable year only by the amount of such tax as computed under the amendments made by section 501 of the Revenue Act of 1942.

(g) [as amended by Section 501 of the Revenue Act of 1942] *Stock Redemption Credit.*—An amount equal to the portion of the recognized gain, realized within the taxable year and prior to March 3, 1936, from the sale or other disposition of a capital asset, which, pursuant to a contract, was distributed prior to such date to shareholders in redemption in whole or in part of preferred stock and which is not otherwise allowable as a credit under any other provision of this section or section 27.

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

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(h) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under

this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

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Louisiana Acts (1928), Act No. 250:

SECTION 26. DIVIDENDS: METHOD OF ESTIMATING FUND FOR PAYMENT OF.

I. No corporation shall pay dividends in cash or property,

(a) except from the surplus of the aggregate of its assets over the aggregate or its liabilities, plus the amount of its capital stock; or

(b) out of any surplus due or arising from—

(1) any profit on treasury shares before resale; or

(2) any unrealized appreciation in value or revaluation of fixed assets; or

(3) any unrealized appreciation in value or revaluation of inventories before sale; or

(4) the unaccrued portion of unrealized profit on notes, bonds or obligations for the payment of money, purchased or otherwise acquired, unless such notes, bonds or obligations are readily marketable, in which case they may be taken at their actual market value; or

(5) the unaccrued or unearned portion of any unrealized profit in any form whatever, whether in the form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise, except as provided in the preceding subparagraph (4).

II. In case all or any part of any cash dividend is paid out of paid-in surplus, the shareholders shall at the time of payment be notified of that fact.

III. No corporation shall pay dividends in shares of the corporation, except from the surplus of the aggregate of its assets, which, for this purpose only, may include items mentioned in Subdivision I (b), over the aggregate of its liabilities, plus the amount of its capital stock.

IV. In computing the aggregate of the assets of the corporation, for the purpose of dividends, whether payable in cash, property or shares, proper allowance shall be made for depreciation and depletion sustained, and ascertained or known losses of every character. Deferred assets and prepaid expenses shall be considered as assets only to the amounts not used or not accrued.

V. Subject to the limitations contained in this Section, a dividend may be declared in shares of the corporation, whenever the

board of directors so determine, provided that,

(a) if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount of that portion of the corporation's surplus which is transferred to capital as payment for such shares;

(b) if the dividend is paid in shares having no par value, the number of such shares shall be fixed by the board of directors;

(c) no dividend payable in shares of any class shall be paid to shareholders of any other class, unless the articles so provide, or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made.

* * * * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 26–2. [As amended by T. D. 5263, 1943 Cum. Bull. 1003.] *Credit in Connection With Restrictions on Payment of Dividends.*—

* * * * * *

(d) *Deficit corporations.*—Under the provisions of section 26 (c) (3), a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year is allowed as a credit the amount of such deficit to the extent that the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936. Whether such a deficit exists as of the

close of the preceding taxable year is a question to be determined from the facts and circumstances of each particular case. In any such case the taxpayer must show how the deficit arose, whether from operating losses, capital distributions in excess of earnings and profits, or other causes. In addition the taxpayer must show, under a law or an order of a public regulatory body, the extent to which it could not legally have paid dividends during the existence of such deficit. A State law, for example, might permit the payment of a dividend from unrealized appreciation in value of assets even though the corporation had a deficit in accumulated earnings and profits. A deficit in accumulated earnings and profits can arise only out of the operation of the business at a loss and can not be caused by distributions to shareholders in excess of the amount of accumulated earnings and profits. If distributions are made to shareholders out of accumulated earnings and profits, however, such distributions may contribute to the creation of a deficit by so exhausting the accumulated earnings and profits that they are incapable of absorbing a loss thereafter resulting from the business. Unrealized appreciation or depreciation in value of assets is not a factor in determining accumulated earnings and profits.

The application of the provisions of section 26 (c) (3) may be illustrated by the following examples:

Example (1).—The M Corporation for the calendar year 1936 had an adjusted net income of $200,000 but had an actual deficit in accumulated earnings and profits as of December 31, 1935, of $20,000. By

reason of a State law in effect prior to May 1, 1936, with respect to deficit corporations, the M Corporation was prohibited from paying dividends during the existence of such deficit. Under section 26 (c) (3), the M Corporation is allowed a credit of $20,000.

Example (2). Assume in the above example that the deficit in the accumulated earnings and profits is $20,000 for income tax purposes, but the deficit on the corporation's books by reason of a prior capitalization of surplus in the course of a nontaxable reorganization amounts to $250,000. In this case, even though the State law might prevent the distribution of any dividends, the credit under section 26 (c) (3) is limited to $20,000, which is the deficit in accumulated earnings and profits for income tax purposes.

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S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 244–246 (1942–2 Cum. Bull. 504, 683–684):

SECTION 501. ADDITIONAL CREDITS FOR UNDISTRIBUTED PROFITS TAX.

This section is the same as in the House bill, except that a new paragraph to section 26 (c) has been added, providing for an additional credit in cases of corporations having a deficit in accumulated earnings and profits and prohibited by law from paying dividends, and except that a new subsection has been added providing for a stock redemption credit.

* * * * * *

Under section 14 of the Revenue Act of 1936 corporations in general were subject to surtax at various rates from 7 to 27 percent of their undistributed net income.

In some instances State law or an order of a public regulatory body prohibited payment of dividends during the existence of a deficit even though the corporation had current earnings and profits which would constitute undistributed net income under the definition thereof in section 14 (a) (2). Such corporations were, therefore, subject to undistributed profits surtax even though they were prohibited by law from paying dividends. The addition of the new paragraph 3 to subsection (c) of section 26 to provide an additional credit in the amount of the deficit in accumulated earnings and profits as of the close of the preceding taxable year is intended to give relief in certain of these cases.

* * * * * * *

The application of the deficit credits provided by these amendments may be illustrated by the following examples:

(1) The X corporation for the calendar year 1936 had an adjusted net income of $200,000 but had a deficit in accumulated earnings and profits as of the close of the preceding calendar year of $20,000. By reason of a State law in effect prior to May 1, 1936, with respect to deficit corporations, only $180,000 of this adjusted net income could be distributed as dividends. Under section 14 of the Revenue Act of 1936, X corporation would be subject to undistributed-profits surtax on $20,000 even though it paid out the entire amount which it could have distributed without violating the State law—namely, $180,000, as taxable dividends. Under the amendment to section 26 (c), X corporation would be allowed a credit of $20,000, and would not be liable

for any undistributed-profits tax for the calendar year 1936.

(2) Assume in the above example that the deficit in accumulated earnings and profits is $20,000 for income tax purposes, but the deficit in accumulated earnings and profits on the corporation's books by reason of a prior capitalization of surplus in the course of a nontaxable reorganization amounts to $250,000. In this case, although the State law would probably prohibit payment of any dividends, the credit allowed under the amendment to section 26 (c) is limited to $20,000, which is the deficit in accumulated earnings and profits for income tax purposes. X corporation, therefore, will be liable for undistributed profits surtax on $180,000 of its adjusted net income.

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